

Why Do More Companies Fail? The Different Types of Corporate Crisis and the Main Causes of Bankruptcy

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Abstract

The business crisis is a very current and debated topic. Knowing the typology of the crisis and the causes that generated it helps a lot of rehabilitation and its success. However, the literature has not given much weight to these issues while the methods of evaluating companies have been extensively studied to identify the indicators of the crisis. The objective of this research is to focus on the different types of crises and their behavior, considering the causes that led companies in difficult situations. After reviewing the literature, I conducted an analysis of the most important types of corporate crises, and I examined the causes that could lead to business disruption.

Keyword: *Insolvency, bankruptcy, economic-financial crises, inefficiency, overcapacity, rigidity*

Introduction

Over the last few years and with ever-increasing pace, corporate crises have ceased to be episodic phenomena and have become recurrent and widespread events.

In all market economies, the life of the company takes place with an alternation of positive and negative phases; in this sense, corporate crises are permanent components of the modern economic system.

The business crisis is a systemic phenomenon that affects the entire company and materializes in a continuous degenerative process.

The strategy to adopt when the company wants to solve the crisis must be forward-looking and change-oriented.

This document begins with the analysis of the different types of corporate crises according to their attitude, and then continue with the identification and analysis of the causes of the crisis that an entrepreneurial context can encounter

Literature review

First, I proceeded to analyze the literature of reference, and in particular, I sweated the scientific contributions concerning the issues of insolvency and bankruptcy. From this initial analysis, I have found a lack of organic documents on the nature of a business crisis and causes of insolvency. I have studied these texts:

- Robert E. Kalaba, Terence C. Langetieg, Nima Rasakhoo, Mark I. Weinstein, *Estimation of Implicit Bankruptcy Costs*, The Journal of Finance, 1984
- Luigi Gutri, *Crisis e risanamento delle imprese*, Giuffrè Milano, 1986
- Hubert Ooghe, Sofie De Prijcker, *Failure processes and causes of company bankruptcy: a typology*, Management Decision, 2008
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- Paolo Di Martino, Michelangelo Vasta, *Companies' insolvency and 'the nature of the firm' in Italy, the 1920s–70s*, The Economic History Review, New Series, 2010

- N Wilson, A Altanlar, *Company failure prediction with limited information: newly incorporated companies*, The Journal of the Operational Research Society, 2014
- Minnie Throop England, *Economic Crises*, Journal of Political Economy, 1913

The other texts studied and used for the realization of this work are reported in the references section.

Idea

An enterprise is in crisis when the economic and financial situation is deteriorating, and it is impossible to stop the process with the available forces.

The outcome of the company's crisis is the recovery of value or the elimination of the company from the market.

The nature of the crisis can be of different types depending on its attitude; there are generally three different situations:

1. financial crises;
2. economic crises;
3. economic-financial crises.

Companies in a financial crisis do not have adequate financial resources to meet the needs of economically balanced management.

The financial crisis manifests itself in several ways:

- forced renunciation of investments;
- impossibility to find financial resources;
- impossibility to change the financial structure.

In the financial crisis, the company has not adjusted promptly and consistently the financial structure to make it suitable for its activities in an economical way.

The ratio between risk capital and debt capital must be adequate. The capital of risk is linked to the capitalization in the strict sense of the company while the debt capital is linked to the financial structure of the company

The economic crisis is independent of the aforementioned financial crisis of a simple qualitative and quantitative lack of financial resources.

In general, the economic crisis derives from the demand for goods and services that are the object of production and supply of the company.

In relation to the demand for the goods and services in the production and supply of the company, to understand the nature of the economic crisis, just think about the stagnation or downturn in demand.

Regarding the second point, think of the higher production costs.

The economic crisis manifests itself when the company is not able to express a reorganization program and a production reorganization that allows it to return to the economy and to the management equilibrium.

The company owes the remuneration:

- debt capital;
- the capital for restructuring;
- the capital for the implementation of the reorganization program.

If it is not possible, it can be said that it is a company in an economic crisis.

The economic crisis must be faced with precise choices and assessments, which must take into account more factors and more elements. This is a requirement to carry out an assessment of the expediency, which concerns the possibility of remunerating a capital equal, at least, of the presumable liquidation value of existing investments. This means that it is possible to suffer from a loss of liquidity of the company.

While it is said, that society faces an economic-financial crisis when all the characteristics of the crisis mentioned above coexist, in this situation, the economic imbalance is attributable to an excessive financial burden because the investments were not productive and generated significant losses. However, the enterprise can be said to be vital until it is able to remunerate the capital it actually employs.

In the economic-financial crisis, there are certainly more points of contact with the economic crisis than the financial crisis. The greatest similarity between the economic-financial crisis and economic crisis is represented by the presence of an important loss of the entity. However, while in the economic-financial crisis the loss has already been suffered and we must proceed towards financial systematization.

Now we see the identification and analysis of the causes of a corporate crisis that can be conducted according to two approaches.

The first approach considers the causes of a subjective nature based on human factors or facts or acts performed by individuals operating in the company: the only source and the only protagonist of the success and failure of economic activity is the human factor. From this point of view, the activity carried out at various levels by the various subjects responsible for corporate policy decisions is relevant to identify the cause of the crisis. According to this vision, the inability to manage and administer is solely responsible for the bad performance of the business.

Secondly, the criticisms are aimed at the property as the crisis arises from the wrong policies, for example:

- excessive distributions of dividends, which have removed economic and financial resources from commercial activities and have prevented proper development and correct evolution;
- the fear of risk that is the fear of market evolution or technological innovations or new commercial outlets;
- the reluctance to provide guarantees to creditors and the concern to expose personally and economically in support of the company project;
- the wrong choice of management with the assignment of important tasks to naive or incompetent people.

Finally, the crisis can be subjective if the workers involved in the production, organization, and sale are ineffective or negligent. The constant verification of the correct performance of the tasks assigned to each person must be the basis for the correct administration and management of the company's activity. The inadequate behaviour of some subjects must be detected promptly and appropriately so as not to create negative effects on all company activities.

Ultimately, according to this orientation, the subjects / protagonists of company life are usually at the origin of the company crisis because of their defects, their behaviour, and their incapacity.

However, this type of approach to the problem is not the most significant and most suitable for describing the complexity of the reality of the corporate crisis. Considering only the human factor as the main or prevailing cause of the corporate crisis is reductive and wrong.

An objective-type scheme helps more the description and analysis of the causes of the crisis. The composition and the choices of protagonists of the business life are not the only variables to analyze, but external factors are fundamental because they are not always predictable and governable.

From this perspective, we can distinguish five basic types of crises, depending on the causes that origin them:

- inefficiency crisis;
- overcapacity/stiffness crisis;
- product decay crisis;
- crisis due to lack of programming/innovation;
- financial imbalance crisis.

The factors indicated above do not always present themselves as exclusive causes of the crisis but are often combined to generate an intricate plurality of causes.

This approach is more articulated and specific and requires the simultaneous verification of various factors and multiple causes.

The crisis is determined by reasons of inefficiency when one or more sectors of the company's business operate with returns that are not "in line" with those of the competitors. The area in which this situation is most evident is the production area. Various reasons can result in higher costs than the industry average, or higher than the best competing companies. Some possible causes of this situation are:

- the availability of obsolete production tools;
- lack of capacity or low workforce commitment;
- the use of non-updated technologies;
- the unpleasant dislocation of the plants.

The analysis of technological inefficiency occurs through two paths:

1. analysing the level of product costs (the company's product costs must be compared with those incurred by the main competing companies);
2. considering the efficiency indexes (for example the production speed of the individual machines, the processing time of every single product, the quantity of energy used, the associated processing waste).

However, verification of efficiency ratios requires detailed and complete information without which there may be partial or misleading results. The state of inefficiency obviously does not concern only the production area, but can also invest other areas of activity. For example, the inefficiency of the company may depend on the commercial sector as the marketing costs are disproportionate compared to the results generated.

Instead, typical situations of efficiency in the administrative sector are:

- excessive bureaucracy;
- serious shortcomings in the information system;
- unsatisfactory operations.

In the organizational field, inefficiencies are manifested above all in the lack of means of planning and control.

Finally, the conditions of efficiency are recognized by the higher cost of the available financial means, compared to the competition. The two fundamental causes that may underlie this phenomenon are:

- 1) the company's contractual weakness;
- 2) the inability of the employees in the financial department.

Ultimately, the inefficiency crisis can affect various areas and is determined by a plurality of factors that can interact and co-exist.

Instead, overcapacity or stiffness crises arise from:

- a lasting reduction in the volume of demand for the company, originating from phenomena of production overcapacity at the level of the entire sector;
- a lasting reduction in the volume of demand for companies associated with the loss of market shares;
- a development of revenues lower than expected, against fixed investments for larger dimensions.

Finally, yet importantly, a particular case of overcapacity crisis occurs when costs increase but do not increase prices that are controlled by the state.

The lasting reduction in the volume of demand for the company leads to phenomena of over-production capacity in the entire sector and outlines a typical hypothesis of crisis deriving from an excess of production capacity compared to the possibilities of the market.

Corporate crises from overcapacity have as a rule explanation in sectoral phenomena. Typical cases of sectoral overcapacity are:

1. overcapacity generated by the search for economies of scale;
2. overcapacity caused by the fall in global demand (consumers change their tastes);
3. overcapacity determined by new and strong import currents;
4. overcapacity determined by the existence of high barriers to the exit;
5. overcapacity caused by errors in forecasting the demand;
6. overcapacity is resulting from managerial policies.

The negative effects of sector overcapacity are reflected more or less heavily on individual companies, depending on the reaction that the company can demonstrate in terms of market shares.

In reality in this situation, the crisis develops only if the company does not adapt the costs to the change in revenues. The process of cost adjustment is an essential moment that generates a crisis. In this case, the administrative bodies must supervise the progress of the activity in a particular and penetrating manner and must be willing to modify the cost plan according to the demand. However, it is not always possible to proceed with the modification or adjustment of the cost plan, as in some cases the constraints and situations cannot be managed. The main categories of costs for which adaptation difficulties arise are fixed costs (the costs of the company structure) and labour costs. In the first case, the adaptation processes are feasible with alternative productions; in the second case, the adaptation processes are feasible with the simplification of the company apparatus.

The rigidity crisis is also linked to the lasting reduction of company demand linked to the loss of market shares. In this case, there are no manifestations of overcapacity in the whole sector but only in the company: the difficulties appear more serious because they are connected to specific weaknesses of the company. The only possibility of avoiding the crisis is a prompt process of cost adjustment. This solution often requires courageous and painful interventions that are not always easy to implement.

Another type of rigidity crisis occurs when revenues are lower than pre-established investments. The situation described may result in one of the following cases: insufficient increase in market share or incorrect forecast for the development of global demand.

Once the excess capacity has been formed, the company has two options:

1. wait for the natural development of the demand to reabsorb excess capacity (conservative attitude);
2. adopt aggressive market policies, conquering previously unexplored areas of product diffusion (inartistic attitude).

The last type of stiffness crisis derives from the increase in costs, not counterbalanced by price changes subject to public control. The phenomenon is characteristic of periods of inflation, when the costs move upwards rapidly, while the price trend occurs with delay and sometimes partially.

Product decay crises derive from a reduction in positive margins between prices and costs; in this case, the margin falls below the limit to cover the fixed costs and is not sufficient to guarantee a profit margin. The operating instruments used to measure the phenomenon are the gross margin and the contribution margin. The formulas compare the (average) price of a given product with an (average) cost, but in both cases, the cost is defined differently. The gross margin parameter refers to a calculated cost of the product, excluding costs not easily attributable to the individual product; while the contribution margin criterion refers to a calculated cost of the product excluding fixed costs. Changes in margins at sector level can have these motivations:

- cyclical fluctuations of the margins;
- margins trend linked to the product life cycle;
- margins change for new competitors.

In some cases, the lack of programming and innovation is the cause of the axiendal crisis

The inability to program is understood as an inability to:

- adapt the management conditions to environmental changes;
- study and prevent change.

Lack of planning means inability to involve management and staff in general in carrying out management. The programs must be clear and precise for everyone, but when the objectives are uncertain and uncertain, negative reactions are generated.

Another significant factor of crisis is the lack of innovation. The company must always consider:

- new products,
- new markets,
- new ways of production,
- new ways of presenting and disseminating products,
- increase customer loyalty.

In general, the company must have a constant ability to study new growth opportunities and valid development combinations. Hardly a prudent policy allows the survival of the company.

Most of the time, the corporate crises are attributed to financial imbalances and the unbearable burdens deriving from them.

The causes of financial imbalance are:

- serious lack of equity (by way of capital) and corresponding net prevalence of debt instruments,
- significant prevalence of short-term payables compared to the other categories of indebtedness,
- imbalances between investments long-term financial resources and permanently available funds,
- insufficiency or inexistence of liquidity reserves, for scarce or no capacity of the company to contract the credit conditions
- difficulties to follow and to face the deadlines.

The sequence of events normally follows the next development: when the financial imbalance occurs, there are significant economic losses (caused by high financial charges) that generate the state of insolvency.

Obviously, the situation described above can undergo variations and may behave differently in relation to specific events. A more in-depth analysis leads to identify the development of events with the following cadences: the factors of crisis (inefficiency, rigidity, decay, etc.) produce economic losses that in turn generate financial imbalances, subsequently an aggravation of the economic losses that finally leads to the state of insolvency.

The financial imbalance is often associated with another type of imbalance that can be defined as “capital” and consists of the scarcity of capital resources.

Conclusions

The corporate crisis is a more or less prolonged moment in the life of the company in which the operating conditions present significant elements of difficulty; it may have origins of an economic or financial nature, which over time often find many elements of contact, although not necessarily the one the cause or the origin of the other.

The causes of a corporate crisis can be subjective and objective; in particular, according to this second meaning, there are crises due to inefficiency, overcapacity/rigidity, the decay of products, lack of programming/innovation and financial imbalance.

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